Constellation: Management Report 4Q17

Long Only Performance	Fund (USD)	MSCI Brazil (USD)
4Q17	-2.60%	-1.87%
2017	34.00%	24.11%
Annualized return since inception	14.03%	5.61%

In 2017, the MSCI Brazil was up 24% and the Constellation Long Only fund was up 34%. This compares to an average EPS growth rate of 20% and a dividend yield of 2.2% for our portfolio. The quantitative performance of our businesses is obviously very important, but what sets our companies apart is what they did last year to become stronger competitors in their industries. Last year, almost all our companies delivered what we expected: they strengthened their competitive positions, invested for growth, improved the management teams and strengthened their balance sheets. Some of them with flying colors. For example:

Fleury had a great 2017, executing its expansion plan at full throttle. After announcing, in the end of 2016, the plan to open between 73 and 90 new stores in 4 years, the company has added 32 new stores in the last 12 months alone – increasing approximately 10% the area of their patient service centers. Fleury has also added 7 new hospitals to their network of partners, growing its relevance in the B2B segment. We expect a 14% growth in net revenues in 2017, translating into a 27% addition in EBITDA (we estimate ~2.5pp margin expansion from 2016 to 2017) and 37% in net income – outstanding numbers, even more so if we consider that 2015 and 2016 were already great years for the company. Last year Advent International exited their investment made in late 2015. After two years of solid achievements, the private equity firm sold their entire position, elevating the free float to 60% and improving Fleury's stock liquidity. Finally, in the last revision of the Ibovespa Fleury was included with a 0.701% weight.

CVC also had a very good 2017, with 11.5% same store sales, total bookings growth of 15% and 110 new exclusive stores opened. It also made two accretive and strategic acquisitions: Trend and Visual Turismo. Those acquisitions increased not only CVC's market share, but also its capabilities in different segments and information advantage relative to its peers, which enables the company to help its suppliers with distressed inventory, improving relationships. Digitalization efforts were also a highlight last year, and the impact on consumer experience should be relevant from the second half of 2018 on. For this year we also expect the favorable consumer environment to sustain bookings growth, and the bottom line to improve due to synergies captured from Trend and Visual acquisitions.

B3 had a transformational year with the merger with Cetip, creating a dominant powerhouse in the Brazilian financial markets and becoming the 5th largest global exchange by market cap. The integration has been evolving as expected and the management team is working hard to keep widening B3's business moat, based on a vertically integrated network platform. In 2017, we estimate that EBITDA will grow 12%, driven mainly by strong volumes. We remain very excited with the company's prospects as it is ready to capture the benefits of the improved economic activity in Brazil (more IPOs, debt issuance, investments, money inflows, etc). Given its strong operational leverage, we expect distinctive earnings growth in this scenario, accelerating growth vs 2017.

Lojas Renner's investments in the last couple of years allowed it to start 2018 in a solid position relative to its peers in terms of number of stores, distribution infrastructure and financial services. Increased real estate availability enabled the company to open 68 stores in 2017, accelerating sales area growth to 11.9%, compared to 9.6% in 2016, while push & pull logistics were already responsible for more than 100bps in same store sales growth. We expect the company to have delivered 15% top line growth and 20% bottom line growth in 2017, and to accelerate its earnings growth in 2018, helped by the improvement on household income.

Raia Drogasil had a solid year and once again was an outperformer in its sector. To illustrate, in the last 12 months, the company delivered an EBIT addition equivalent to the entire EBIT of the 3rd largest player! We see Raia as a typical example of "the strongest getting stronger" as it consistently builds pillars to keep expanding the gap against peers. Its best-in-class management team maintained a high-quality growth and execution, opening more than 200 stores last year and expects to accelerate the pace to almost 250 new stores per year in the next few years. We are happy to be a part of this successful story and understand that there is still more to come. In 2018, we expect Raia to continue delivering a strong set of results, accelerating earnings growth and strengthening its distinctive competitive position.

Rumo's operational performance and balance sheet improvement were the main highlights of the investment case in 2017. We expect the company to have delivered strong results with a robust 35% EBITDA growth, driven by the successful operational improvements led by its best-in-sector management team. Rumo also strengthened its balance sheet, de-risking the investment case significantly: The company raised BRL 2.6bn in an equity offering and BRL 2.3bn in bonds. We expect an even better 2018, as Rumo is expected to deliver double digit EBITDA growth coupled with high profit growth in 2018.

These are just some examples of incumbents growing strong at the start of the economic upturn. Our economic backdrop for Brazil in the last few quarters has been based on the upturn of three cycles: the political, economic and earnings cycles. After two terms of a center-right government (Fernando Henrique Cardoso), followed by three terms of a left-wing party (Lula and Dilma), the political pendulum has now shifted to the center-right again. This is not a Brazil only phenomenon; the same happened recently in Argentina and Chile. It is too early to tell who the presidential candidates will be, but we believe chances are that a center-right candidate will prevail in the October 2018 election. In the meantime, underneath the political noise the economy will continue to improve. After a severe three-year recession, the economic cycle is turning up. In January of last year growth expectations for 2018 were at 1.6%. Today, we expect GDP to grow 2.7% this year. We are already seeing improvements in some relevant sectors like auto sales, construction and durable goods.

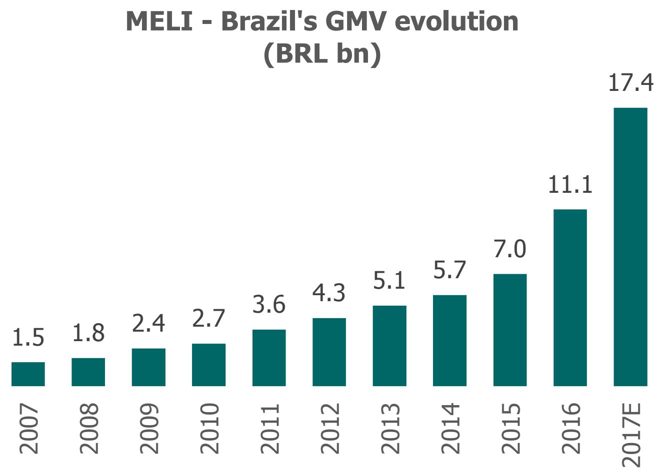
The acceleration in GDP growth should lever the earnings growth cycle. As we have been writing in our recent letters, companies in Brazil had to become more efficient during the low growth years. We expect a strong acceleration in earnings in the next two years, and this is the basis on which we are building our portfolio. We expected earnings for our portfolio to grow 26%, and the dividend yield to be 3% in 2018.

At the beginning of every year, investors force themselves to make predictions and believe that the coming year is going to be volatile and challenging. The truth of the matter is that there is always going to be volatility; there are going to be rallies and corrections due to unexpected news. If a market friendly president is elected, there may even be a bubble. It is business as usual in EMs. At Constellation, we shall focus our energy in studying businesses. One of the most exciting businesses in our portfolio today is Mercado Libre.

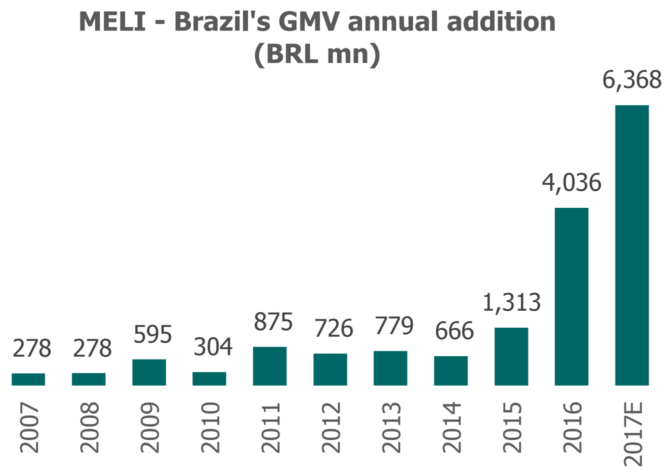
Mercado Libre

Mercado Libre (MELI) is an online marketplace, and the leading e-commerce platform in Latin America. It is the leader in all the 3 largest markets (Brazil, Mexico and Argentina) and has been widening its dominance by enhancing the network effect that is present on its platform. It is widely known that retail is going through a digital transformation, and we see Mercado Libre in a unique position to benefit from this trend. We see it as an investment opportunity in a great company that is still on its early stages of development.

The graph in the next page shows the Gross Merchandise Value (GMV) evolution on MELI's platform in Brazil, that represents 75% of its cash flow. We can see that the growth (GMV addition) has been accelerating, and in 2017 alone MELI added the equivalent of Via Varejo online GMV – the 3rd largest e-commerce player in Brazil.

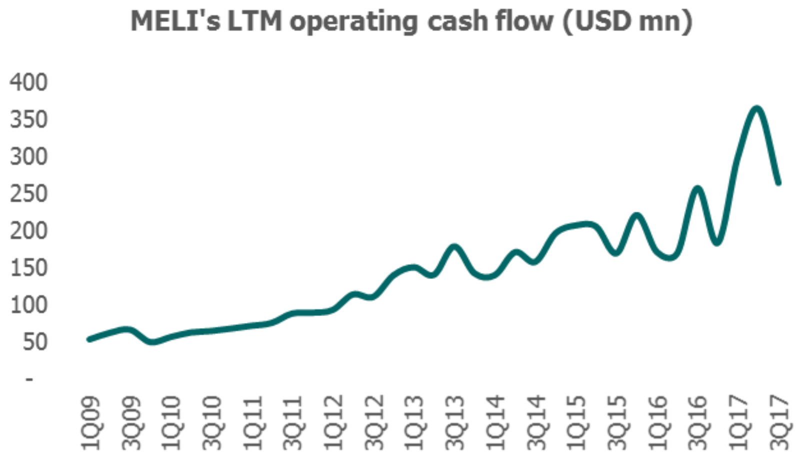


Source: Constellation estimates.



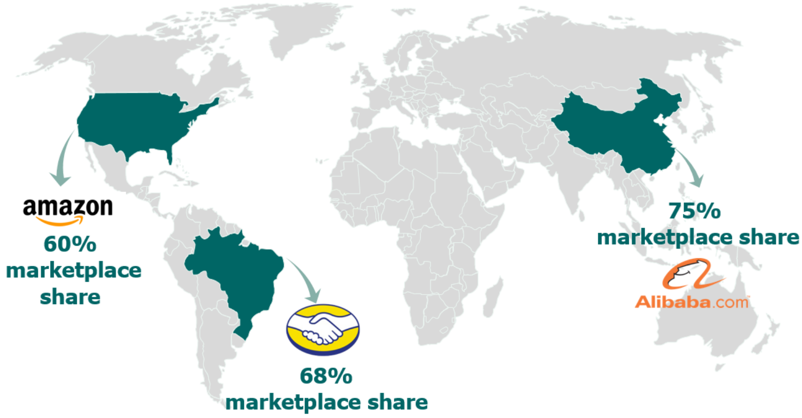
Source: Constellation estimates.

In addition to its huge growth potential, Mercado Libre also has one of the most profitable business models in our portfolio. As a pure marketplace, MELI does not sell any owned merchandise, it connects buyers and sellers, and charges different kinds of fees when the transaction happens. Due to MELI's payment settlement terms, it has a negative net working capital, creating a formidable ground for its growth. MELI has grown more than tenfold in the past ten years, while generating cash consistently and not requiring additional equity.



Source: companies' reports and Constellation estimates.

MELI's strategy is to continuously remove friction in the sales process, fostering buyer stickiness and attracting more sellers which further enhances the assortment in the platform. This creates a positive feedback loop that is known as network effect. It is very hard to reach the critical mass that creates this effect; however, when that happens, the higher the number of users in the platform, the higher the value of the platform for its users, the market share tends to concentrate, and the value creation can be exponential. Mercado Libre, Facebook, Google, Amazon, Alibaba and B3 are examples of platforms that have this network effect, and they all share an important characteristic: very high returns on invested capital.



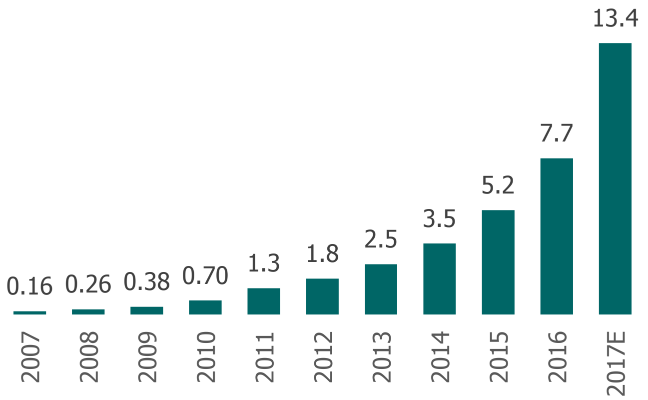
Source: Euromonitor, e-Bit, companies reports and Constellation estimates.

In order to keep developing its platform, enhance its relevance and reach this critical mass, some years ago MELI decided to elevate the user experience to a different level by getting involved in all steps of the sale process. This involvement has been particularly intense in the payment and in the shipping process.

Payment conditions in the past were mostly negotiated between buyer and seller. In 2003, MELI introduced Mercado Pago, which created a standard payment solution like Paypal, enhanced the trust in the system (if a buyer gets an inadequate product, the seller will not receive its payment), and started what can be seen today as one of the largest fintechs in Latin America.

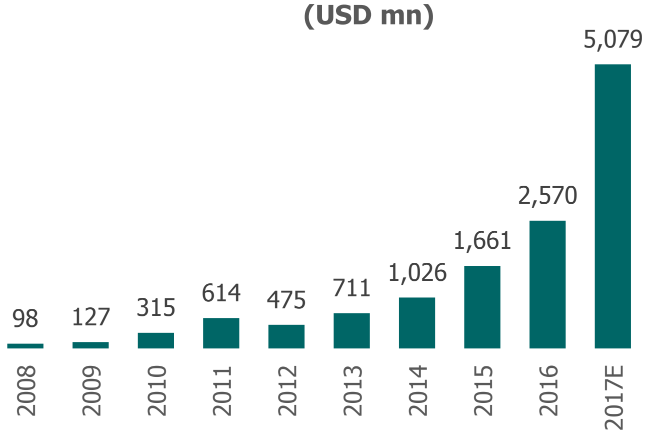
We estimate that MELI had a USD 11.5bn GMV in 2017, while Mercado Pago processed a total payment volume (TPV) of USD 13.4bn on its platform in the period, which makes it one of the largest of its kind in Latin America. Around 30% of this volume was outside Mercado Libre's platform, and this is currently the fastest growing segment.

Mercado Pago's TPV evolution (USD bn)



Source: companies' reports and Constellation estimates.

Mercado Pago's TPV annual addition (USD mn)



Source: companies' reports and Constellation estimates.

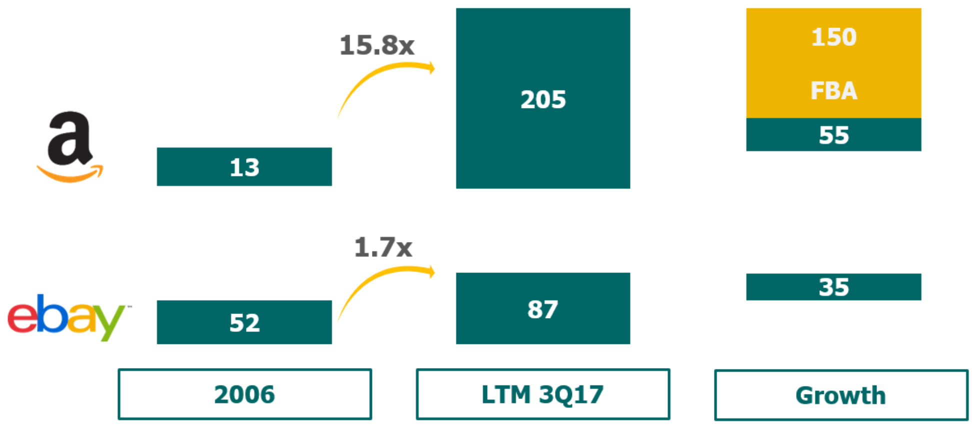
MELI has more than 30 million active users and 10 million active sellers on its platform, and is in a good position to create businesses around its ecosystem. One example of a new business in the platform is credit for small and medium businesses. Serving small businesses has always been a challenge for the banking system globally and MELI has most of the key information used for credit approval in this segment: how much the seller has been selling, how much the seller has sold but not yet received, and, on top of that, it is the largest sales channel for that seller. Once that merchant is already connected to Mercado Pago's platform, MELI can offer credit in a very user friendly way.

Shipping execution is key since it is the only moment when the buyer has physical contact with its e-commerce purchase. Getting it wrong may jeopardize the whole value proposition of the platform, so MELI has been putting a lot of energy into making it better. In 2013, MELI started a partnership with Correios that standardized the experience, made it easier for buyers and sellers to estimate the shipping cost and provided tracking, improving the overall reliability of shipping.

In 2015, MELI took the next step in the shipping evolution: a cross docking solution with independent carriers. After that, in 2017, the company introduced an integrated logistic solution called Mercado Envios Full, which allows the sellers to have high turnover items in a distribution center managed by MELI. The result of this evolution is that delivery is getting faster and more reliable.

As an analogy, in 2006, the e-commerce penetration in the US retail market was around the penetration in Brazil today (3.8%). At that time, eBay had a GMV that dwarfed Amazon's, and it was the year that Amazon introduced its integrated logistic solution to its sellers in the marketplace, called Fulfilment by Amazon (FBA). The figure below shows that, 11 years later, the situation is very different, and the bulk of the difference was where FBA was used, providing very strong evidence that FBA was key to improving service level on Amazon's platform, driving its impressive outperformance.

GMV (USD bn)



Source: companies' reports and Constellation estimates.

Although MELI has been through several consecutive years of strong growth, we still see it in the early stages of the realization of its potential, the flywheel is just gaining momentum. In the 3Q15 MELI was not yet the leader in Brazil, and its GMV represented 70% of B2W, the leader at the time. Two years later, MELI delivered a GMV that is equivalent to 150% of the former leader's GMV, and we expect the gap to widen further. We estimate MELI's last 12 months market share at 27%, but MELI's market share on the market growth is 50%, that is, we see the company poised to gain material market share.

MELI's current assortment in Brazil (around 65mn SKUs) is around 12x the number of SKUs in the 2nd largest platform, B2W, which combined with a solid shipping experience is very hard to compete with. But this assortment is still a fraction of global leaders like Amazon (600mn SKUs) and Alibaba (900mn SKUs), and should still grow a lot as the feedback loop keeps attracting new sellers.

It is very difficult to find such an enormous growth potential, combined with returns on invested capital as high as 50%, and the opportunity to allocate additional capital at such high returns. Big opportunities like this attract competition, and we think MELI is better positioned than ever to deal with this challenge: it has the largest base of buyers and sellers, largest assortment, its service level is continuously improving, and consequently buyers are becoming even more engaged (increasing spending per customer). On top of that, we also see one of the best management teams in place for the challenge.

This year marks the 20th year since we started a proprietary portfolio for 3 families, the original Constellation Fund. It also marks 30 years since I started as an intern in the financial industry. It has been a fascinating and very humbling journey. We are very grateful for the efforts of our team, the trust of our investors and the insights from our peers. We couldn't have done it without all of you.

The next 30 years are going to be challenging in different ways. When we started in the business, managing talent was not considered important, after all there was a line of young, talented and hungry people wanting to work in finance. This has changed. Now, most college kids want to start their own business or be involved with NGOs or politics. This is a good thing for Brazil, but poses challenges for us in terms of retaining and attracting talent. In a low interest rate environment, demand for equity analysts will also increase. There is a generational gap in equity talent in Brazil (very few wanted to be involved with equities in the last few years). I am convinced that we have the best team ever, but we must work hard to continue providing room to grow, learning opportunities and new challenges for our high potentials. If we spent 10% of our time motivating and coaching, now we must spend 30/40%. Managing the business has become as important as managing the portfolio.

Picking stocks is also more difficult these days. For a long time, there wasn't a lot of discussion regarding the quality of the people or sustainability of our businesses. We did not spend much time discussing if Ambev, Itaú, Lojas Renner had good management or if their business would be disrupted; it was mostly a matter of earnings growth and paying the right multiples. With the wave of new companies going public and the potential disruption all industries will go through (only the timing and intensity will vary), there is much more uncertainty and risk. Our job changed for sure.

These changes are risks but also exciting opportunities. We feel a little scared, but also energized looking for the next 30 years. The second half of the game is beginning, and we believe we have the best team and investors to thrive in the new environment.

We value your relationship and the trust you have placed in us by investing in Constellation. Our investor relations team will be glad to answer any further questions.

Sincerely,

Constellation team